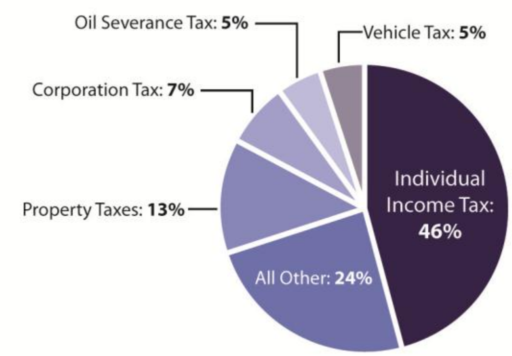
MONTANA BUDGET & POLICY CENTER

Policy Basics
June 2012

Introduction to Montana's Corporate Income Tax

For generations, our tax dollars have served as shared investments in the programs and services that make our state a great place to live, work, and play. Tax dollars enable Montanans to work together to achieve things which we could not do alone - educate our children, build and maintain infrastructure, provide public safety through police and fire protection, keep our air and water clean, and pave the way to a stronger and more inclusive economy. Corporations that operate in Montana (whether they own property, pay staff, or sell products) are required to pay a tax as a percentage of their net income earned in Montana. In turn, corporations benefit greatly from our shared investments. For example, corporations hire educated workers, utilize infrastructure, and benefit from Montana's legal system.

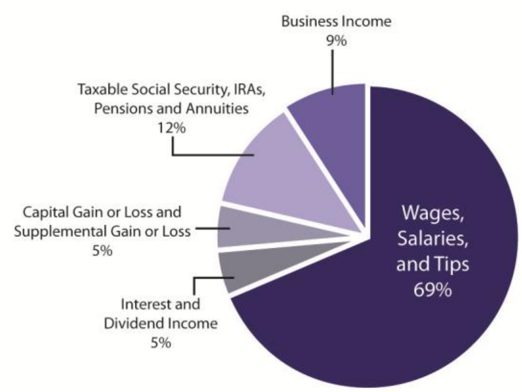
Chart 1: Corporate Taxes Only Make Up 7% of General Fund



Source: Legislative Fiscal Division

In Montana, most of our shared investments are managed through the state's "general fund." Taxes make up the vast majority (84%) of the revenue for the General Fund. In 2010, Montana collected $88 million in total corporate taxes, making up less than 7% of state taxes (Chart 1).[1]

Chart 2: Business Income Is Just 9% of Reported Personal Income



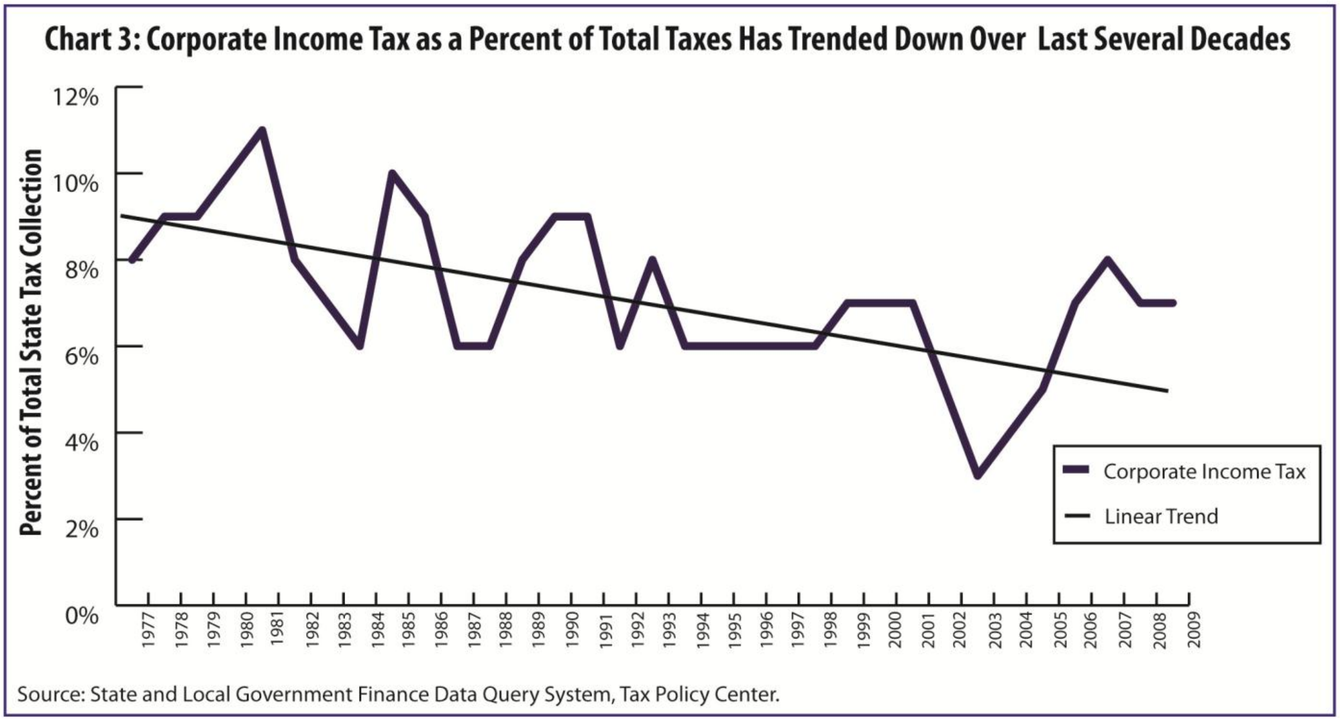
Source: Montana Department of Revenue, 2009

In general, taxes paid by corporations are paid through the corporate income tax. However, depending on how a business is structured, business income may actually be reported through the individual income tax. Specifically, if the business is structured as a C corporation its taxes would be classified as corporate taxes. (Businesses that chose to structure as C corporations get benefits associated with that status, including limited liability and access to capital

Policy Basics is a series of background reports on issues related to the Montana budget and Montana taxes. The purpose of the Policy Basics series is to provide the public, community advocates, and policy makers the tools they need to effectively engage in important fiscal policy debates that help shape the health and safety of our communities.

markets.) All other businesses, including sole proprietorships, partnerships, limited liability corporations, and S-corporations, report income on individual returns. Taxes on business income make up just 9% of total income subject to individual income taxes (Chart 2).

Nationally, corporate taxes as a percent of the economy have declined over the last several decades. In the 1950's corporate taxes as a percent of the national economy averaged 5%. Over the last decade, that rate has dropped to 2%.[2] Likewise in Montana, corporate taxes have been declining since the late 1970s, making up a smaller and smaller portion of total state taxes (Chart 3).



Most Montana Corporations Pay the $50 Minimum

In 2010, Montana had over fourteen thousand C corporations, and only 32% of them paid more than the $50 minimum corporate tax (Chart 4). According to Montana's tax code, corporations pay either 6.75% of their net income earned in Montana or $50, whichever is greater.[3]

The phenomenon of corporations paying little to no state taxes has been well-documented nationally. A recent national study found that 68 profitable Fortune 500 companies paid no state income taxes in one of the past three years (2008-2010).[4] For example, in 2010, Verizon Communications made a profit of almost $12 billion but paid no state income taxes in any of the states where they operated.[5] In fact, Verizon received $42 million in tax refunds from states, making their state tax rate negative. Two hundred and sixty-five of the large profitable corporations in the study paid only half of the expected state taxes based on their profits.[6]

Many profitable corporations are able to avoid paying state corporate income taxes because of:

1. Federal credits and deductions with which Montana automatically complies,
2. State level tax loopholes for which corporations have successfully lobbied, and
3. Creative accounting utilized by corporations.[7]

Chart 4: Most Corporations Pay the Minimum $50 Tax

Source: Department of Revenue, 2010

The minimum corporate tax in Montana has been $50 since 1969.[8] Had this tax kept up with inflation, today's minimum amount would be $313.[9] Updating the corporate minimum tax to account for past inflation and making sure it automatically adjusts for future inflation would modernize our tax system and slow the decline in corporate income taxes. Increasing the corporate minimum tax to $313 would raise approximately $2.5 million in additional revenue.[10] As costs rise for providing the basic public services, infrastructure, and education that benefit corporations, the contributions of those corporations should rise too.

Some Good News: Montana Has Been a Leader in Combined Reporting

Combined reporting is an important policy tool that prevents corporations from utilizing a variety of tax avoidance strategies. Montana has been a leader in this area and has been using combined reporting for decades. A majority of states with corporate income taxes now utilize combined reporting.[11]

What is Combined Reporting?

Many large companies consist of a parent company and its subsidiaries. Combined reporting requires a parent company to add its income and its subsidiaries' incomes for the purposes of state corporate income taxes. Montana then taxes its share of the total income based on the level of activity in Montana. States without combined reporting are vulnerable to a wide array of tax avoidance strategies by corporations. The tax avoidance strategies usually involve artificially shifting profits to subsidiaries that are in states without corporate income taxes or that do not tax a specific type of subsidiary.

Combined reporting ensures that corporations pay their fair share of taxes in Montana based on their corporate activity in Montana. In addition, it improves fairness for smaller Montana-based companies. Local companies do not have subsidiaries across the country to which they can shift profits. Without combined reporting, large, multistate companies could engage in tax avoidance strategies that give them a competitive advantage over smaller, local businesses.

Outdated Tax Havens List Limits the Effectiveness of Combined Reporting

Montana requires worldwide combined reporting, which means that corporations with common ownership must report all income worldwide, unless they make a "water's edge election." The water's edge election allows multinational corporations to only report their income from the

United States, rather than their worldwide income. In exchange, these companies agree to pay a 7% tax rate, rather than the normal rate of 6.75%.

There are some limits to the water's edge exclusion of international income. If a subsidiary is located in a country that is a known tax haven, the corporation may not exclude that subsidiary's income even under the water's edge election. In order for this exception to be useful and avoid inappropriate income shifting, the list of tax havens must be updated regularly in Montana law. The 2011 Montana Legislature failed to pass a bill (Senate Bill 94) that would have expanded the list of known tax havens and tighten other rules regarding the water's edge election. If passed, the bill would have raised approximately $2 million per year and improved fairness for smaller, local companies.[12]

Net Operating Loss Carryback Worsens Montana's Fiscal Challenges in Downturns

The net operating loss carryback, a relatively obscure and costly feature of the income tax code, allows businesses experiencing an operating loss in the most recent tax year to file amended tax returns for the three previous years, deducting the current year's loss against any profits earned in those previous years.[13] The corporation can elect to receive a refund or apply the refund to the next year's tax liability. Montana is one of only 15 states that still allow the net operating loss (NOL) carryback deduction.[14] Unlike Montana, many of these states limit the amount of losses that companies can carryback.[15]

The NOL is particularly harmful during economic downturns. Individuals and corporations earn less during downturns and, in turn, tax revenue to the state decreases. Allowing businesses to receive a refund for previously paid taxes serves only to further compound Montana's revenue problems during downturns. As a result, the state may struggle to fund essential public services like education, healthcare, prescription drug and child care assistance at a time when many Montanans need them the most. Eliminating the NOL carryback would bring in much-needed revenue, decrease the volatility of corporate tax revenues, and avoid unnecessary, self-inflicted fiscal damage for the state.

If the NOL carryback were eliminated, businesses could still utilize the NOL carryforward. This provision allows businesses to carry their net operating losses forward and deduct them against future profits, providing tax relief for corporations during difficult times, but not at the expense of fiscal responsibility.

Corporate Tax Expenditures

Tax expenditures are often described as ''silent spending.'' They come in the form of preferences such as tax deductions, exemptions, deferrals, exclusions, credits or lower tax rates given to individuals or businesses. Tax expenditures are considered a form of spending because they allocate funds for specific public purposes, but not through direct appropriations. These expenditures are commonly referred to as tax loopholes or incentives. They have a significant impact on state revenue as they reduce or eliminate revenue that would have otherwise been collected. Tax expenditures are not inherently good or bad policy. However, just like other state spending, they should be reviewed and evaluated on a regular basis to evaluate whether they are meeting the intended goals.

The Department of Revenue creates a report of tax expenditures each biennium. However, there is no requirement that tax expenditures are reviewed regularly by the Legislature. Corporate tax expenditures cost Montana over $11 million per year.[16] For more information about tax expenditures see Montana Budget and Policy Center's 2011 report, Flying Under the Radar: Time to Evaluate Tax Expenditures.

A Costly and Ineffective Tax Expenditure: The Domestic Production Deduction

The domestic production deduction is one example of a corporate tax expenditure. The federal government created the "domestic production deduction," in 2004. Because Montana bases its tax code on the federal tax code, the tax break was implemented in Montana without any consideration by state lawmakers. In other words, Montana is losing millions of dollars to a corporate tax break that never even received a vote in the state legislature.

This tax expenditure allows companies to claim a tax deduction based on certain domestic production activities (e.g. filmmaking, mining, and construction). Companies can claim the deduction for qualified activities that occur anywhere in the United States, so corporations may get the deduction in Montana even if they do not engage in production here. For more information about the domestic production deduction, see Montana Budget and Policy Center's 2011 report, Montana Can Bypass a Costly and Ineffective Federal Tax Break for Corporations.

Reforms for a Stronger Montana

All Montanans want a strong economy where small businesses can thrive, where workers can support their families, and where our children can stay in Montana and find meaningful work. To create a more inclusive and prosperous economy for future generations, we must continue to invest in our education systems, in our infrastructure, and in the health and safety of our communities. The corporate income tax is one way that we pool our resources to make sure that those investments happen. The following reforms would modernize Montana's corporate income tax system and strengthen our ability to invest in a stronger and more inclusive economy:

- Adjusting the minimum tax for inflation,
- Repealing the net operating loss carryback,
- Expanding the list of tax havens under the water's edge provisions,
- Requiring the review or sunset of tax expenditures, and
- Decoupling from the federal domestic production deduction.

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[1] Montana Department of Revenue, "Biennial Report: July 1, 2008- June 30, 2010," December 2010, http://revenue.mt.gov/publications/biennial_reports/default.mcpx and Legislative Fiscal Division, "General Fund Revenue History by Revenue Source," September 1, 2011, http://www.leg.mt.gov/content/Publications/fiscal/Historical_Perspective/General%20Fund%20Revenue%20History.pdf.

[2] Linden, Michael et al., "Ten Charts that Prove the United States Is a Low-Tax Country," Center for American Progress, June 10, 2011, http://www.americanprogress.org/issues/2011/06/low_tax.html.

[3] Montana Department of Revenue, "Biennial Report: July 1, 2008- June 30, 2010," December 2010, http://revenue.mt.gov/publications/biennial_reports/default.mcpx.. Because of privacy restrictions, data is not available on which corporations paid the minimum of $50.

[4] Institute on Taxation and Economic Policy and Citizens for Tax Justice, "Corporate Tax Dodging in the Fifty States, 2008-2010," December 2011, http://ctj.org/ctjreports/2011/12/corporate_tax_dodging_in_the_fifty_states_2008-2010.php.

[5] Ibid.

[6] Ibid.

[7] Ibid.

[8] Montana Code, Chapter 11, section 1 of the Extraordinary Session, 1969.

[9] U.S. Bureau of Labor Statistics, "CPI Inflation Calculator," June 4, 2012, http://www.bls.gov/data/inflation_calculator.htm.

[10] MBPC calculation.

[11] Mazerov, Michael, "A Majority of States Have Now Adopted a Key Corporate Tax Reform — "Combined Reporting"," Center on Budget and Policy Priorities, April 3, 2009, http://www.cbpp.org/cms/index.cfm?fa=view&id=246.

[12] Governor's Office of Budget and Program Planning, "SB 0094 Fiscal Note 2013 Biennium," April 26, 2011, http://data.opi.mt.gov/bills/2011/FNPDF/SB0094.pdf.

[13] Montana Annotated Code 15-31-119.

[14] Montana Department of Revenue, "Biennial Report: July 1, 2008- June 30, 2010," December 2010, http://revenue.mt.gov/publications/biennial_reports/default.mcpx.

[15] Mazerov, Michael, "Minority of States Still Granting Net Operating Loss "Carryback" Deductions Should Eliminate Them Now," Center on Budget and Policy Priorities, May 11, 2009, http://www.cbpp.org/cms/index.cfm?fa=view&id=2760.

[16] Montana Budget and Policy Center, "Flying Under the Radar: Time to Evaluate Tax Expenditures," February 14, 2011, http://www.montanabudget.org/sites/default/files/reports/Tax%20Expenditures.pdf.